

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
REPLY BRIEF**

77-7060

To be argued by
ANTHONY L. TERSIGNI

United States Court of Appeals

FOR THE SECOND CIRCUIT

HOWARD M. LASKER and IRVING GOLDBERG,

Plaintiffs-Appellants,

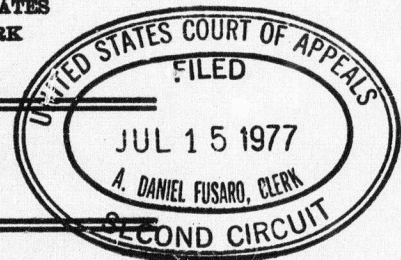
—against—

HARRY G. BURKS, JR., EDWARD B. BURR, THOMAS F. CHALKER, JOHN R. HAIRE,
HARVEY C. HOPKINS, S. P. HUTCHISON, DONALD L. KEMMERER, A. S. MIKE
MONRONEY, CHARLES F. PHILLIPS, JEPHTHA H. WADE, ANCHOR CORPORATION
and FUNDAMENTAL INVESTORS, INC.,

Defendants-Appellees.

ON APPEAL FROM ORDERS AND JUDGMENT OF THE UNITED STATES
DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

APPELLANTS' REPLY BRIEF



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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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HOWARD M. LASKER and IRVING GOLDBERG,
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Plaintiffs-Appellants,
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-against-
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HARRY G. BURKS, JR., EDWARD B. BURR,
THOMAS F. CHALKER, JOHN R. HAIRE,
HARVEY C. HOPKINS, S. P. HUTCHISON,
DONALD L. KEMMERER, A. S. MIKE MONRONEY,
CHARLES F. PHILLIPS, JEPHTHA H. WADE,
ANCHOR CORPORATION and FUNDAMENTAL
INVESTORS, INC.,
:
Defendants-Appellees.
:
-----X

APPELLANTS' REPLY BRIEF

POINT I

DEFENDANTS CITE NO PRECEDENT WHATSOEVER WHICH SUPPORTS THEIR ASSERTION THAT THE BUSINESS JUDGMENT RULE AUTHORIZES TERMINATION OF A VALIDLY COMMENCED SHAREHOLDERS' DERIVATIVE ACTION.

Defendants have tried to create the impression that there exists a line of cases empowering a board of directors to terminate a validly commenced shareholders' action on the

basis of "business judgment" (Appellees' Br., pp. 15-20).

In fact, the authority relied on by defendants is to the contrary.

That defendants' legal position falls outside the pale of established precedents is evident from the fact that Judge Werker himself characterized the present case as "unique" (147A). Furthermore, as we pointed out in our main brief (p. 32), Judge Werker's decision has been criticized as an unwarranted "extension" of the business judgment rule.

Defendants cite a string of cases standing for the proposition that before a shareholder can sue derivatively he must make a demand on the board, unless a majority of the board consists of alleged wrongdoers in the action or is subject to the control of the alleged wrongdoers, in which case demand is excused and the shareholder may proceed with the litigation.* In this category are the following cases: United Copper Securities Co. v. Amalgamated Copper Co., 244 U.S. 261 (1917); Corbus v. Alaska Treadwell Gold Mining Co., 187 U.S. 455 (1903); Hawes v. Oakland, 104 U.S. 450 (1882);

* As stated in our main brief (pp. 21, 32-33), defendants have never disputed the fact that a demand on the Fund's board is legally excused in the present case (147A).

Brody v. Chemical Bank, 517 F.2d 932 (2d Cir. 1975);* In re Kauffman Mutual Fund Actions, 479 F.2d 257 (1st Cir.), cert. denied, 414 U.S. 857 (1973); Ash v. IBM, 353 F.2d 491 (3d Cir. 1965), cert. denied, 384 U.S. 927 (1966); Swanson v. Traer, 249 F.2d 854 (7th Cir. 1957); Bernstein v. Mediocredito Banca di Credito, 69 F.R.D. 592 (S.D.N.Y. 1974); Findley v. Garrett, 240 P.2d 421 (Cal. Dist. Ct. App. 1952). The demand criteria of these cases having concededly been met in the present case, the cited authorities support, rather than negate, plaintiffs' right to litigate their claims on the merits (Appellants' Br., pp. 32-33).

Defendants rely on the following state court cases, not cited in the district court's decision, applying the business judgment rule as a defense on the merits to charges of directorial liability: Ella M. Kelly & Wyndham, Inc. v. Bell, 266 A.2d 878 (Del. 1970); Moskowitz v. Bantrell, 41 Del. Ch. 177, 190 A.2d 749 (1963); Beard v. Elster, 39 Del. Ch. 153, 160 A.2d 731 (1960); Puma v. Marriott, 283 A.2d 693 (Del. Ch. 1971). These cases, involving litigation on the merits, have nothing to do with a board determination regarding the maintenance of derivative actions.

*

In Brody, relied on heavily by the court below (147A-149A), after the litigation had commenced a demand was held necessary and a completely new board chosen by a court-appointed trustee in bankruptcy. Unlike the present case, no member of the board was a defendant in the action or had been selected by, or was under the control of, a wrongdoer.

Defendants also cite Alleghany Corp. v. Kirby, 344 F.2d 571 (2d Cir. 1965), cert. dismissed, 384 U.S. 28 (1966) and Goodwin v. Castleton, 144 P.2d 725 (Wash. 1944), neither of which supports, or even involved, a claim of power to abort a validly commenced derivative action. The Alleghany case, in fact, was not a derivative action, but rather, an action brought by the corporation itself. Following a dismissal on the merits and an unsuccessful appeal, the board of directors determined not to petition for certiorari. Two shareholders petitioned to intervene, but their petition was denied. The case hardly stands for the proposition that directors have the power to terminate a validly commenced derivative action. In Goodwin v. Castleton, a board of directors proposed that certain derivative claims be settled -- not dismissed without judicial scrutiny of the merits. The court held a two-week trial and, after reviewing the merits, made specific findings, including that the settlement was supported by adequate consideration and was in the best interests of the corporation and its stockholders (144 P.2d at 731). Defendants' quotation from the Goodwin case at page 19 of their brief is misleading in that the quoted language in no way relates to any claim of power to abort validly commenced litigation as was done in the present case. The expression of an opinion by directors in support of a proposed settlement, the adequacy of which is subject to court review, is one

thing. A claim of power to abort stockholder litigation without judicial scrutiny of the merits is totally different and unsupportable, particularly when a majority of the board consists of defendants in the litigation sought to be terminated.

Finally, defendants cite Gall v. Exxon, 418 F.Supp. 508 (S.D.N.Y. 1976). This case was decided after the present case and simply followed Judge Werker's decision. In addition, Gall did not involve a federally regulated mutual fund and did not present any of the Investment Company Act issues presently before this Court.

The inappropriateness of defendants' claim of business judgment as a bar to the present action is further illustrated by Birnbaum v. Birrell, 17 F.R.D. 409 (S.D.N.Y. 1955), a case which defendants ignore. Birnbaum involved a proposed settlement approved by an independent board, on the basis of which dismissal of the action was sought. The court noted the following contentions, strikingly similar to those of defendants in the present case:

"It is...urged that since the settlements have the approval of an independent directorate unconnected with the origin of the litigation and one which is peculiarly fitted to make a decision in the exercise of its honest business discretion, the purpose of Rule 23(c) [now 23.1] is served without judicial inquiry into the merits of the settlements" (Bracketed words added) (Id. at 411).

* * *

"...[I]t has been suggested that if the court determines that the directors are acting as proper corporate representatives without self-interest, it 'need inquire no further into the merits of the settlement; the corporation is then as free to act as if it had been the original plaintiff'" (Ibid.).

Nevertheless, the court explicitly rejected defendants' theory finding that it "does not appear to have any authoritative support" (Ibid.). It reached this result despite the fact that there, unlike the present case, not a single director was a defendant in the action (Id. at 410).*

None of the cases cited by defendants upholds the business judgment of a minority of an adversely interested board as a purported basis for barring stockholder litigation. To the contrary, the basic logic of the demand cases precludes such a result since a minority of an adversely interested board is conclusively presumed to be controlled and is thus disqualified from exercising discretion with respect to the litigation. It would make no sense to place the prosecution of an action under the ultimate control of a majority opposed to its success, even if the minority would choose to sue (see Appellants' Br., pp. 27-28, 32-33).** Thus, an affirmation of the decision below by this Court would overturn, in effect, a long line of cases excusing demand where a majority of the board is adversely interested in the litigation.

* See also Groel v. United Electric Co. of New Jersey, 61 Atl. 1061 (N.J. Ch. 1905) in which the court refused to permit directors of a corporation to abandon a meritorious derivative claim of \$20 million on the basis of their purported "business judgment" since to do so would have resulted in a gross injustice to the corporation and its shareholders.

** If the minority directors in the present case had sought to take over the action in the name of the Fund, obviously control of the action would then have been in the hands of the defendant majority of the board.

Defendants are also unable to cite a single case under the Investment Company Act in which a board of directors was permitted to frustrate shareholder prosecution of a derivative action alleging fraud and gross abuse of trust by fiduciaries. Plaintiffs, on the other hand, have referred to Papilsky v. Berndt, 503 F.2d 554, 556 (2d Cir. 1974), cert. denied, 419 U.S. 1048 (1974) and Baffino v. Bradford, 57 F.R.D. 79, 81 (D. Minn. 1972) for the proposition that a mutual fund board does not have discretionary authority to prevent prosecution of a derivative action to enforce claims for fiduciary misconduct under the Investment Company Act (Appellants' Br., pp. 11-12). Defendants make a feeble attempt to distinguish these cases on the ground that in neither one "did the Board actually exercise its business judgment" (Appellees' Br., p. 47). The point of the cases, however, to which defendants again are unable to respond, is that such a business judgment would have been futile to bar the litigation. Thus, this Court in Papilsky stated:

"[I]f (as might well be anticipated) a majority of the board refuses to sue, plaintiffs presumably would then be permitted to reinstitute their present action" (503 F.2d at 556).

At trial in the Papilsky case, Judge Frankel noted that it would be "quixotic" to permit a mutual fund board hostile to a derivative action to abort its prosecution, notwithstanding the fact that an absolute majority of the board consisted of non-defendant, disinterested directors. Papilsky v. Berndt, CCH Fed. Sec. L. Rep. ¶95,627 at pp. 90,129 - 90,130 (S.D.N.Y. 1976).

Defendants are similarly unable to respond to Boyko v. The Reserve Fund, Inc., 68 F.R.D. 692 (S.D.N.Y. 1975), in which Judge Gagliardi held, on the demand issue, that the presence of a single affiliated director on a mutual fund's board constitutes conclusive evidence that the board is controlled, thus precluding any need for a demand on the board prior to instituting a derivative action (Appellants' Br., pp. 29, 33; cf., Appellees' Br., pp. 43-44). While the specific section involved in Boyko was Section 36(b) of the Investment Company Act, the underlying rationale of Judge Gagliardi's decision is equally applicable in the present case (68 F.R.D. at 696).

POINT II

SECTION 1(b) OF THE INVESTMENT COMPANY ACT MANDATES THAT THE ACT BE INTERPRETED IN A MANNER THAT WILL MOST MEANINGFULLY EFFECTUATE ITS POLICIES AND PROTECT PUBLIC SHAREHOLDERS FROM THE ABUSES OF MUTUAL FUND ADVISERS AND DIRECTORS.

In support of their theory of the supremacy of the business judgment rule, defendants assert:

"The courts have long recognized that the management of a corporation's affairs--including the decision whether or not to prosecute litigation--rests solely with the board of directors, and absent fraud, corruption, or other invalidating factors, the board's decision is final" (Appellees' Br., pp. 15-16).

In relying on this argument, drawn from traditional concepts of state corporation law, defendants totally ignore the fact that the management of mutual funds is federally regulated and subject to overriding congressional restrictions and policy limitations and that, in reality, a mutual fund is not a truly independent corporation, but a controlled shell. This Court itself has described the typical structure of the externally managed open-end mutual fund as "a mere shell whose investment and management functions are performed by an adviser...." Fogel v. Chestnutt, 533 F.2d 731, 734-35 (2d Cir. 1975), cert. denied, ___ U.S. ___ (1976); see also Tannenbaum v. Zeller, 552 F.2d 402, 405 (2d Cir. 1977).

As discussed in our main brief (pp. 17, 36-37), Section 1(b) of the Investment Company Act requires this Court to interpret the Act in the manner most conducive to the protection of the interests of mutual fund shareholders. The section states:

"It is declared that the policy and purposes of this subchapter, in accordance with which the provisions of this subchapter shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors" (Emphasis added).

This Court is thus under a specific congressional mandate to interpret the provisions of the Investment Company Act in a manner that will fully effectuate its purposes, particularly

so as to ensure that investment companies are managed in a manner that will most meaningfully protect and safeguard the interests of their shareholders. The Act must be interpreted so as to provide maximum protection of shareholders' rights, not the minimum protections afforded by traditional state corporation law concepts vesting managerial supremacy in the board of directors. Section 1(b) itself requires that plaintiffs in the present case be permitted to prosecute their claims of fraud and gross abuse of trust under the Act.

POINT III

PLAINTIFFS' IMPLIED RIGHTS OF ACTION UNDER SECTION 36 OF THE INVESTMENT COMPANY ACT AND SECTION 206 OF THE INVESTMENT ADVISERS ACT WOULD BE RENDERED MEANINGLESS IF THEIR ENFORCEMENT COULD BE BARRED BY THE PURPORTED BUSINESS JUDGMENT OF THE MINORITY DIRECTORS.

The courts, particularly this Court, have long upheld implied rights of action under Section 36 of the Investment Company Act and, more recently, under Section 206 of the Investment Advisers Act (Appellants' Br., pp. 9-10). It is axiomatic that such rights, to be meaningful, must be enforceable, particularly in view of the congressional mandate

contained in Section 1(b) of the Investment Company Act. In the present case, the net effect of terminating this litigation on the basis of the purported exercise of business judgment by minority directors would be the complete abandonment and frustration of the rights of the Fund's shareholders in favor of those whose conduct Congress sought to regulate.

Both before this Court and in the district court, defendants have been unable to meet this point. The plain fact is that their interpretation of the business judgment rule, if adopted by this Court, would defeat rights which the federal courts have been mandated to uphold.

Defendants fallaciously contend, without citation of authority, that in the absence of an express statutory provision to the contrary, minority directors should have the right to terminate an action, like the present one, for gross misconduct by regulated insiders. This reasoning is unsound both legally and logically. If followed, implied rights of action could not exist at all, since in each instance it could be argued, as defendants argue, that if Congress had intended to accord a right of action, "it could and would have done so" (Appellees' Br., p. 37; see also Point VI, infra). In accord with Section 1(b) of the Act, the

presumption should be in favor of the enforceability of claims based on fiduciary misconduct in the absence of clear legislative intent to the contrary.

Defendants also cite the Supreme Court's decisions in Santa Fe Industries, Inc. v. Green and Cort v. Ash, which they suggest stand for the "primacy of state law on questions relating to the power of directors... " (Appellees' Br., p. 37). Once again, defendants ignore the fact that the Investment Company Act operates as a "corporation law for investment companies," particularly with respect to "the protection of...investors against the derelictions of...directors, investment advisers" and others. Brown v. Bullock, 194 F.Supp. 207, 233 (S.D.N.Y. 1961), aff'd, 294 F.2d 415 (2d Cir. 1961). Such legislation was "intended to provide effective federal regulation" (original emphasis) over investment companies and their advisers. Abrahamson v. Fleschner, CCH Fed. Sec. L. Rep. ¶95,889, at p. 91,275 (2d Cir. 1977). In short, the present case is governed by a federal, not state, standard of directorial responsibility. See Rosenfeld v. Black, 445 F.2d 1337, 1345 (2d Cir. 1971). If there could be any remaining doubt as to whether state law concepts of directorial powers or the prophylactic policies of the Investment Company Act ought to govern the present case, it was resolved by Chabot v. Empire Trust Co., 301 F.2d 458, 462 (2d Cir.

1962), in which this Court emphasized the necessity for adequate independent scrutiny through stockholder actions brought to enforce the Act. Defendants' version of the business judgment rule would defeat the objective of independent scrutiny and should, therefore, be rejected.

POINT IV

DEFENDANTS' UTILIZATION OF THE QUORUM PROVISIONS OF THE FUND'S BY-LAWS VIOLATES SECTION 17(h) OF THE INVESTMENT COMPANY ACT.

Defendants' assertion that the Section 17(h) argument was not raised before the district court (Appellees' Br., p. 39) is erroneous. See Index to Record, Document 56, pp. 34-35.

Section 17(h) of the Investment Company Act provides that neither the charter nor the by-laws of an investment company shall contain any provision which "protects or purports to protect" any officer or director of an investment company from liability for gross misconduct (Appellants' Br., pp. 12-13). In the present case, the quorum provisions of the Fund's by-laws were the sine qua non without which the minority directors were legally disabled from acting for the Fund's board.

Section 141(b) of the Delaware Corporation Law provides in part:

"A majority of the total number of directors shall constitute a quorum.... [T]he by-laws may provide that a number less than a majority shall constitute a quorum which in no case shall be less than one-third of the total number of directors..." (Emphasis added).

Thus, were it not for the quorum provisions of the Fund's by-laws, the minority directors, under Delaware law, would have been prevented from attempting to exercise business judgment with respect to this litigation or any other question. Since the procedure of a "disinterested quorum" would have been impossible without the relevant quorum provisions of the by-laws and since the quorum's determination, if sustained, clearly would protect defendants from liability for gross misconduct, it is undeniable that the by-laws in this case are being used in a manner which violates Section 17(h).

Defendants argue that the Fund's quorum provisions do not purport to exculpate defendants from liability. They attempt to distinguish Chabot v. Empire Trust Co. on the ground that in that case there was an express security for expenses provision, which had "the practical effect of shielding the trustee from liability by preventing lawsuits" (Appellees' Br., p. 39). By the same token, in the present case, insofar as the Fund's quorum provisions were the source of the minority's authorization to act for the full board, the

by-laws must ipso facto be deemed to have the same "practical effect of shielding the [defendants] from liability by preventing lawsuits."

As in Chabot, the violation of Section 17(h) results not from the literal words of the by-laws themselves (nothing in the security for expenses provision in Chabot literally prevented the trustee from being sued and found liable) but rather, as defendants themselves point out, from the practical effect of protecting directors from liability. In accord with the congressional mandate of Section 1(b) that the provisions of the Investment Company Act be interpreted so as to eliminate, not foster, fiduciary abuses, the Fund's by-laws, being the basis for the result reached in the court below, must be deemed to have been utilized in a manner violative of the provisions and underlying policies of Section 17(h).

POINT V

TERMINATION OF THIS ACTION BY THE
FUND'S MINORITY DIRECTORS WOULD IN
EFFECT CONSTITUTE AN IMPERMISSIBLE
RATIFICATION OF FRAUDULENT AND IL-
LEGAL CONDUCT.

In Arthur Lipper Corp. v. S.E.C., 547 F.2d 171, 179 (2d Cir. 1976) this Court made it clear that the board of directors of an investment company cannot sanction the per-

petration of a fraud by the investment adviser (Appellants' Br., p. 19).^{*} That will be the practical result, however, if the dismissal of this action is sustained.

In response, defendants merely argue in substance that there is a technical difference between a decision not to sue and ratification (Appellees' Br., pp. 40-41). Defendants are unable, however, to answer the point made by the Supreme Court of Delaware in Mayer v. Adams, 141 A.2d 458, 461 (Del. 1958) that "[s]trictly speaking, this is true, but the practical result is the same."

The underlying issue here is whether the standing of minority shareholders to sue derivatively may be nullified by action of a minority of the board of directors and whether the wrongs alleged will thereby go unremedied. Defendants' own authority, Kessler & Co. v. Ensley Co., 129 F.397, 400 (C.C.N.D. Ala. 1904), acknowledges that notwithstanding a determination by a board not to sue, a derivative plaintiff may proceed to enforce the claim if he "shows a failure of justice to the corporation." That is clearly the case here.

^{*} The decision of this Court in Fogel v. Chestnutt, 533 F.2d 731 (2d Cir. 1975), cert. denied, U.S., cited by defendants (Appellees' Br., p. 38), involved an exercise of discretion by mutual fund directors as to whether to seek recapture of brokerage commissions, a proper matter for business judgment. The Fogel case in no way supports an alleged exercise of business judgment with respect to a fraud or gross misconduct by an investment adviser, such as is alleged in the present case. Arthur Lipper Corp. v. S.E.C., supra at 180; Tannenbaum v. Zeller, 552 F.2d 402, 429 n.31 (2d Cir. 1977).

In Levitt v. Johnson, 334 F.2d 815, 820n.5 (1st Cir. 1964), cert. denied, 379 U.S. 961 (1965), cited in our main brief (p. 21), the court, relying on Section 1(b) of the Investment Company Act, refused to require a derivative plaintiff to make a demand on shareholders (even if required by state law) because the effect would have been to frustrate enforcement of the prophylactic policies of the Act. Defendants attempt to distinguish Levitt on the ground that it dealt with a demand on shareholders, rather than directors, thereby completely ignoring the rationale on which the decision was based (Appellees' Br., p. 42). If the shareholders of a fund, the very beneficiaries of the Investment Company Act, cannot be permitted to frustrate its enforcement, how can directors, whom the Act seeks to regulate, be permitted to do so?

Citing In re Kauffman Mutual Fund Actions, 479 F.2d 257 (1st Cir.), cert. denied, 414 U.S. 857 (1973), defendants state that "the Court of Appeals for the First Circuit expressly reaffirmed the responsibility and power of directors to control litigation in actions under the Investment Company Act, by holding that a demand on directors in such actions is required..." (Emphasis added) (Appellees' Br., p. 42). This statement is grossly inaccurate factually. The court in Kauffman specifically noted that the "plaintiff's antitrust claim" was "the only one relevant to this proceeding" (479

F.2d at 261) (Emphasis added). Indeed, plaintiff's standing to prosecute his Investment Company Act claims was specifically upheld by the Third Circuit in a separate proceeding. Kauffman v. Dreyfus Fund, Inc., 434 F.2d 727, 732, 738 (3d Cir. 1970), cert. denied, 401 U.S. 974 (1971).

Defendants cannot realistically refute the fact that dismissal of this action at the instance of the minority directors would be tantamount to impermissible ratification of fraud and illegality. The bottom line is that if the minority's determination is allowed to stand, serious wrongs will have gone unremedied, in clear contravention of the policies of the Investment Company Act and sound judicial authority.

POINT VI

THE INVESTMENT COMPANY ACT DOES NOT
(AND THIS COURT SHOULD NOT) VEST SO-
CALLED DISINTERESTED DIRECTORS WITH
ULTIMATE DECISION-MAKING AUTHORITY
IN THIS CASE.

As discussed in our main brief (pp. 22-27), a review of those instances in which disinterested directors have been granted discretion by statute demonstrates that such directors are intended to have limited powers and certainly are not intended by Congress to be final arbiters able to cut off fundamental shareholder rights to protection against fiduciary misconduct. Nor should such directors be accorded dispositive discretion by the courts over a matter of such importance as whether litigation involving gross misconduct and abuse of trust by insiders should be aborted.

Defendants have failed to address themselves to

the substance of this rationale. Instead, they respond with the judicially discredited reasoning that shareholders should have only those rights to judicial review which are expressly granted by statute (Appellees' Br., pp. 43-44). Thus, they argue that by enacting Section 36(b) Congress spelled out an express right of action regarding advisers' compensation and that if Congress had intended the same with respect to Section 36(a), "it could and would have done so..." (Appellees' Br., p. 44).

Obviously, if defendants' reasoning were correct, there could be no implied rights under any of the securities laws. In Brown v. Bullock, 194 F.Supp. 207, 224 (S.D.N.Y. 1961), aff'd, 294 F.2d 415 (2d Cir. 1961), Judge Herlands, in upholding the implied right of action under Section 36, expressed the correct view:

"Implied rights of action are not contingent upon statutory language which affirmatively indicates that they are intended. On the contrary, they are implied unless the legislation evidences a contrary intention."

Accordingly, the focus of the inquiry should not be, as defendants argue, where did Congress say that directors could not abort, within their "business judgment," enforcement of the fiduciary standards of the Act, but rather, where did Congress say, or even suggest, that they could do so. See Matter of

Fundamental Investors, Inc., CCH Fed. Sec. L. Rep. [1961-64 Transfer Binder] ¶76,887 at pp. 81,268-269 (S.E.C. 1962).

There is no evidence whatsoever of congressional intent that treatment of shareholder claims under Section 36(b) should not apply equally to the enforcement of claims arising under Section 36 (now Section 36(a)) on which the present action is based. Congress' mandate in Section 1(b) creates a compelling presumption in favor of shareholder enforcement of the fiduciary standards of Section 36. Moreover, the legislative history of Section 36(b) adds additional strong support for this conclusion:

"Although section 36(b) provides for an equitable action for breach of fiduciary duty as does section 36(a), the fact that subsection (b) specifically provides for a private right of action should not be read by implication to affect subsection (a)" (Emphasis added) (Senate Report No. 91-184, 91st Cong., 2d Sess., 3 U.S. Code Cong. & Admin. News 4897, 4911 (1970)).

In short, defendants are patently in error when they argue that the express protections of Section 36(b) are a basis for inferring limitations on a shareholder's right to proceed under Section 36(a), or former Section 36.

This Court has emphasized that mutual funds are controlled shells and has recognized the inadequacy of disinterested directors to protect shareholders' interests (Ap-

pellants' Br., pp. 22, 27). Defendants are unable to explain why in the present case the Fund's shareholders deserve less protection than, for example, with respect to insider transactions under Section 17(a) or advisory fees under Section 36(b), in both of which cases disinterested directors have no power to nullify shareholder protections. Even more is at stake in the present case and, if anything, even greater protection is warranted.

POINT VII

DEFENDANTS DO NOT ADDRESS PLAINTIFFS' CONTENTION (POINT IV) THAT THE PROCEDURE SANCTIONED BY THE DISTRICT COURT WOULD FRUSTRATE PRIVATE ENFORCEMENT OF THE FEDERAL SECURITIES LAWS.

Defendants' sole response to Point IV of plaintiffs' main brief (pp. 27-31) is the incorrect contention that plaintiffs' position is unsupported by authority. Defendants do not, and cannot, deny that affirmance of the district court's decision would sanction a device by which mutual fund insiders could escape liability for serious charges of fiduciary misconduct (Appellees' Br., pp. 45-46).

POINT VIII

DEFENDANTS' POSITION WITH RESPECT TO THE MERITS OF PLAINTIFFS' CLAIMS IS UNRESPONSIVE AND UNSUPPORTABLE.

Our main brief (pp. 34-37) discusses three separate reasons why the merits should be judicially reviewed. Defendants are totally silent as to the first two reasons and the supporting authorities (Appellees' Br., pp. 48-50). We submit that they do not respond because they have no meaningful response to make.

Defendants do not deny (not even arguendo) that plaintiffs' claims have merit. They simply argue that the merits should not be considered.

Defendants do not deny that important findings relating to publicly available information concerning Penn Central were not available to Judge Fuld at the time of his report (Appellants' Br., pp. 43-45).

Defendants do not deny that Judge Fuld's opinion was materially qualified (Appellants' Br., pp. 6-7, 42).

Defendants do not deny that Judge Fuld's opinion was premised on what he believed to be an absence of relevant authority (Appellants' Br., pp. 6-7, 39). Judge Fuld recognized: "Concededly, Anchor did not make its own independent investigation of the financial condition of the issuers whose commercial paper was offered to it by selected dealers" (74A).

He went on to state: "I have found no authority, however, which attempts to spell out precisely what this means in the case of an investment adviser" (76A,77A). Appellants' brief (pp. 39-42) cites relevant and persuasive authorities in this regard, including an S.E.C. decision almost directly in point.

The claim that "the disinterested directors in their investigation carefully and fully considered the merits" (Appellees' Br., p. 48) must be discounted in view of their steadfast refusal to review plaintiffs' claims in the light of the authorities and findings which were not known to Judge Fuld at the time of his report.

Defendants do not themselves endorse Judge Fuld's conclusions (Appellees' Br., pp. 48-50).

Defendants themselves initially placed the merits in issue by annexing to their motion the report of Judge Fuld. Having done so, they cannot validly argue that the merits are irrelevant and should be ignored. They make this argument, we submit, only because they are unable to defend their position on the merits.

Finally, defendants do not deny, again because they cannot, that Judge Fuld twice stated that judicial review of the merits is required (Appellants' Br., p. 36).

POINT IX

DEFENDANTS' POSITION WITH RESPECT
TO DISCLOSURE IS SIMILARLY UNRE-
SPONSIVE AND UNSUPPORTABLE.

As discussed in our main brief (pp. 52-59), in no event can there be a valid exercise of business judgment without full and adequate disclosure. This is clear from the decisions of this Court. Tannenbaum v. Zeller, 552 F.2d 402, 417 (2d Cir. 1977); Fogel v. Chestnutt, 533 F.2d 731, 750 (2d Cir. 1975), cert. denied, ____ U.S. _____. In addition, in Fogel v. Chestnutt, supra at 749-50, which defendants cite (Appellees' Br., p. 38), Judge Friendly emphasized the importance of a careful investigation "with an eye eager to discern" and with the assistance of "disinterested counsel."

In the present case, the minority directors were affirmatively misled in some respects and did not have full disclosure in other respects. The fact that Mr. Souther, one of the two counsel who advised the minority directors, was not disinterested within the Investment Company Act definition further violates the criteria of the Fogel case, a fact not recognized by the district court. Overlooking the Fogel case, Judge Werker erroneously concluded that the only consequence of Mr. Souther being an interested person

was to prevent him from serving as a director (Appellees' Br., p. 35).

It certainly cannot be said of the minority directors in this case that their investigation was "with an eye eager to discern." Mr. Stephens testified that in his mind there was a presumption that defendant Hopkins, a friend of thirty years, would not be guilty of negligence (689A-690A). Mr. Laun testified he did not even know the identity of the defendants in the case other than Anchor (1009A-1010A). Mrs. O'Connor testified in substance that she did not consider it appropriate or necessary that plaintiffs or their counsel have an opportunity to present their position as to the merits (984A). Furthermore, the minority directors' refusal to consider plaintiffs' legal analysis illustrates that their attitude has been one of reluctance rather than eagerness.

While such reluctance is undoubtedly due in part to the relationships involved, it is also attributable to a considerable extent to the lack of proper disclosure. Analysis of the "business reasons" set forth in Mr. Kendall's affidavit and Mr. Stephens' letter (Appellees' Br., pp. 11-13 and Addendum) confirms that "full and effective disclosure"

was not made and that there was not an exercise of "informed discretion" by the minority directors. See Tannenbaum v. Zeller, supra at 417-418.

1. Judge Fuld's opinion that the case had no merit.

As discussed in Point VIII, supra, and in our main brief, Judge Fuld was unaware of directly applicable authority (77A, 91A). This includes Matter of Winfield & Co., Inc. (Appellants' Br., pp. 39-40), a case in which Mr. Souther was litigation counsel. The minority directors never had the benefit of a complete legal analysis demonstrating the meritorious nature of the claims they are seeking to dismiss.

2. The alleged inability of Anchor to function effectively if the case proceeded.

As we have indicated, this point was communicated to the minority directors by Haire himself at the December 18, 1974 board meeting, although later expressly disavowed by him (Appellants' Br., pp. 52-56). Why the level of disruption was tolerable for Anchor in the Fund's suit against Goldman, Sachs in which the Fund recouped \$5 million of its Penn-Central losses, but would not be tolerable with respect to this action in which the \$15 million balance is sought, is nowhere explained.

3. The minority's belief that if the action were permitted to continue, an adversary relationship would result between the Fund and Anchor requiring Anchor's termination.

This completely erroneous view, whatever its

origin, was substantially reinforced by Mr. Souther's January 6, 1975 memorandum (199A-204A), in which he discussed the procedure for terminating Anchor. Full and effective disclosure would have required that the minority directors' erroneous view of the consequences of allowing this lawsuit to continue be dispelled, not reinforced.

4. The claim that Anchor acted reasonably and in good faith and followed prudent procedures, including compliance with its own guidelines.

In addition to its conceded failure to conduct any independent investigation as to the advisability of the Penn-Central investment, the record conclusively shows that Anchor also violated its own guidelines by failing to require an agreement by Goldman, Sachs to repurchase the Penn-Central paper and by holding in excess of the 10% ceiling set by the guidelines, amounting to nearly 40% of the outstanding issue at the time of the Penn-Central collapse (Appellants' Br., pp. 46-47). Notwithstanding these undeniable violations of the guidelines, at the December 18, 1974 meeting of the minority directors defendant Haire made a presentation which was clearly misleading in that he "stated his belief that the guidelines had been followed..." (109A). The importance of this particular lack of full and adequate disclosure is obvious from Item #1 of Mr. Stephens' December 31, 1974 letter which indicates his mistaken belief that the guide-

lines had been complied with (Appellees' Br., Addendum, p. "a").

5. The fact that other investors held Penn-Central paper at the time of its collapse.

Anchor was a highly-paid, sophisticated fiduciary with a duty to investigate prior to investing the Fund's money. Its failure to do so constituted a gross abuse of trust and fraud, irrespective of what other investors did or did not do.

6. The claim that two shareholders should not be allowed to determine the Funds' conduct and that at best there could be a net recovery in this action of "little more than" 10¢ per share.

To belittle a meritorious claim of \$15 million amounts to a total disregard of the interests of the Fund's shareholders. As stated in Groel v. United Electric Co. of New Jersey, 61 Atl. 1061, 1064 (N.J. Ch. 1905):

"It is perfectly clear that, if the complainant sets forth a good cause of action and there is a right in the corporation to recover \$20,000,000 of stock from the promoter, it is a clear breach of trust on the part of the directors not to proceed to recover the same. For them to reply that it is by them deemed inexpedient to do so is only to emphasize the breach of trust they are committing by not doing so."

POINT X

THE MINORITY DIRECTORS WERE NOT INDEPENDENT.

Defendants fail to respond to the salient points raised by plaintiffs regarding the minority directors' lack of independence (Appellees' Br., pp. 20-33). Defendants do not and cannot deny that the minority directors were selected by defendants, held office subject to defendants' control and could not have prevailed had they acted contrary to defendants' interests (Appellants' Br., pp. 62-66).

Defendants do not deny that the Fund is a corporate shell, lacking any organizational or operational independence from Anchor. As is clear from the affidavit of James C. Sargent, concerning which defendants are totally silent, true independence is impossible under the circumstances of the present case (Appellants' Br., p. 62).

Unable to respond to the above, defendants focus instead on the personal relationships among the minority directors and the defendants, attempting to portray these relationships as nothing more than "casual" (Appellees' Br., pp. 20-29). The facts are these, however: Laun had known defendant Phillips for twenty-three years as a business and social acquaintance and considered him a friend (1064A-1066A).

O'Connor had known defendant Haire ten years and they were friends (321A-322A). O'Connor had also known defendant Burks for forty years, would see him frequently at social and civic affairs and considered him a friend (920A-921A). Stephens had known defendant Hopkins for thirty years. Their relationship was both business and social (671A-673A). Kendall had known defendant Haire for eight years, considered him a friend and served together with him on the board of a local hospital (470A, 475A-476A, 479A-481A). Kendall also knew defendant Burks with whom he served on the board of their childrens' school (531A-533A).

In addition to the foregoing history, the minority directors and the defendants worked and associated together on at least a monthly basis as members of the various Anchor boards.

Theodore A. Levine, Assistant Director of the Division of Enforcement of the Securities and Exchange Commission, recently stated with respect to independent audit committees:

"The Commission might consider independence tainted if 'outside' officials are members of the same clubs, went to the same schools, or lived in the same neighborhoods as 'inside directors.'" BNA (SRLR), News & Comment, May 4, 1977, p. A-5.

The point is not, as defendants suggest, whether strangers should have been nominated to the Fund's board (Appellees' Br.,

pp. 20-21), but simply that the minority directors lacked the independence necessary to make the particular determination they were called upon by defendants to make.*

Both this Court and the Securities and Exchange Commission have recognized that there exists a presumption of doubt with respect to the independence of disinterested directors generally (See Appellants' Br., pp. 61, 68). Defendants have presented nothing to indicate that the contrary is true in this case.

* Appellees' reliance on Acampora v. Birkland, 320 F.Supp. 527 542-43 (D. Colo. 1963) is inapposite since that case dealt with whether directors were to be deemed "affiliated" within the meaning of the Investment Company Act, not whether they were independent with respect to any specific determination they might be called on to make. Moreover, were Acampora being decided today, insofar as several of the directors had business relationships with the adviser they might well be deemed "interested persons" under Section 2(a)(19)(A)(vi) by virtue of the 1970 amendments to the Act.

Conclusion

The judgment and orders appealed from should be reversed and the case remanded to the district court.

Dated: New York, N.Y.
July 14, 1977

Respectfully submitted,
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ADDENDUM

Delaware General Corporation Law

§141. BOARD OF DIRECTORS; POWERS; NUMBER, QUALIFICATIONS, TERMS AND QUORUM; COMMITTEES; CLASSES OF DIRECTORS; NON-PROFIT CORPORATIONS; RELIANCE UPON BOOKS; ACTION WITHOUT MEETING, ETC.—

...

(b) The board of directors of a corporation shall consist of one or more members. The number of directors shall be fixed by, or in the manner provided in, the by-laws, unless the certificate of incorporation fixes the number of directors, in which case a change in the number of directors shall be made only by amendment of the certificate. Directors need not be stockholders unless so required by the certificate of incorporation or the by-laws. *The certificate of incorporation or by-laws may prescribe other qualifications for directors.* Each director shall hold office until his successor is elected and qualified or until his earlier resignation or removal. Any director may resign at any time upon written notice to the corporation. A majority of the total number of directors shall constitute a quorum for the transaction of business unless the certificate of incorporation or the by-laws require a greater number. Unless the certificate of incorporation provides otherwise, the by-laws may provide that a number less than a majority shall constitute a quorum which in no case shall be less than one-third of the total number of directors except that when a board of one director is authorized under the provisions of this section, then one director shall constitute a quorum. The vote of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors unless the certificate of incorporation or the by-laws shall require a vote of a greater number.